Missouri Division of Finance

UPDATE

A Report of Missouri State Chartered Financial Institutions

Issue 02-01 June 2002

From . . .
Acting Commissioner
D. Eric McClure

The overall condition of our state-chartered banks continues to be good, however, challenges persist in several areas. Capital levels are strong and earnings are good. Asset quality is declining in some of our banks which is often a reflection of the stresses in the economy. The number of our problem banks has increased but remains within our strategic goal of less than fifteen.

The managers of our Missouri banks, in most cases, are successfully meeting the many challenges facing the banking industry. The economy in Missouri is hurting in several sectors and the recovery is slower than desired. The new farm bill should be a positive boost to our agriculture areas. Funds management and the maintenance of good net interest margins is difficult with the large dynamics we have all seen in the interest rate markets. This is a great opportunity for banks to back test their rate sensitivity models. Did the models accurately predict the effect on net interest margins during a year of historic declines in interest rates? This is also a crucial time to shock loan portfolio debt service coverage ratios for rising interest rates.

Consistent predictors of problems that we see include high growth rates as well as non-compliance with internal policies. Banks should ensure they have cultures where adherence to policies is expected and the importance of the fundamentals of banking and lending are recognized and appreciated.

Success is measured by bankers in different ways. Some measure success in growth and others measure success in profitability. We applaud both of these measures but at the beginning of each day, safety and soundness, is the first measure of success that we all must focus on.

GENERAL USURY

Section 408.030 provides that the Director of Finance shall declare the quarterly market rate of interest each quarter, post it in accordance with Section 361.110 and publish it in appropriate publications. Said quarterly market rate for the period July 1, 2002 through September 30, 2002 shall be 8.8%; as an alternative, 10% may be used.

In This Issue:

IDENTITY THEFT AND EMBEZZLEMENT

From OCC Alert 2002-4

We have become aware of fraud schemes involving organized gangs and newly hired bank tellers. Organized gangs are aggressively recruiting bank tellers to cash forged savings account withdrawals from customer accounts and to cash stolen United States treasury checks. Tellers are reportedly being paid several hundred dollars per transaction to assist in this fraud scheme.

Federal law enforcement officials have learned that organized gangs are using coercion and threats of bodily harm to persuade individuals to assist them in the fraud scheme. In some cases, tellers already employed by financial institutions are being recruited. More commonly, individuals are being encouraged by gang members to apply for teller positions at financial institutions for the sole purpose of providing access to the institution's operating systems and customer access information. Typically, the gang member provides stolen information to the teller, who keys the information into the bank's automated system so it will appear as if the customer visited the teller window. The perpetrators are careful to keep amounts under supervisory approval limits and as a result, detection is delayed until the victimized customer reports the fraud.

Banks are advised to exercise care and due diligence in their hiring practices and periodically evaluate internal controls over the teller area. If you have any information or concerns regarding this developing threat of identity theft and embezzlement, please contact the Division of Finance as soon as possible.

STANDARDIZED LOAN INFORMATION FORMAT

Based on an interagency effort to improve examination efficiency, during the second quarter of 2002 examiners will be asking for electronically generated bank loan information to be presented in a standardized format.

Previously, this information was provided in a variety of formats that proved both time-consuming and costly for the regulators, banks and service providers to administer. The new standard provides improved data definitions and a format that will improve the efficiency of the examination process and reduce the burden on all parties involved, including the bank. During the pre-examination planning process, you will be contacted about providing loan information in this standardized format, but participation is purely voluntary. If you have any questions or concerns contact Review Examiner Jerry Janes at the Division office 573-751-3242 or e-mail him at jjanes@mail.state.mo.us.

RECOGNITION

Congratulations to the newest additions to the state banking system. **FirstService Bank** was chartered on January 11, 2002 and is located at 9895 Watson Road, Crestwood, Missouri. They officially opened for business on April 17, 2002 with initial capital of $6,305,000. **The Business Bank of St. Louis** was chartered on March 25, 2002 and is located at 8000 Maryland Avenue, Suite 100, Clayton, Missouri. They officially opened for business on May 16, 2002 with initial capital of $10,495,000.

PATRIOT ACT REMINDER

Senior management is reminded of the continued responsibility to assure internal systems are in place to search for and identify suspect accounts or activity that may be tied to terrorists or parties with suspected links to terrorists. The FBI and Department of the Treasury are frequently updating these lists of names of suspected terrorists, blocked individuals and organizations. You are advised to check these lists frequently on the Internet at http://www.treas.gov/ofac and forward notification of any positive hits by e-mail to suspicious.accounts@ny.frb.org.

STATE BANKING LEGISLATION 2002

The 2002 session of the General Assembly saw the passage of Senate Bill 895, a very lengthy piece of legislation that addresses a number of different issues. The full text of the bill is available on the Internet at www.senate.state.mo.us/02info/billtext/hcs/SB895.htm. A brief summary of the banking related provisions follows:

Section 361.700 is amended to make it clear that electronic transmissions are covered by the sale of checks law;

Section 362.010 is changed to make it clear that bank shareholders' preemptive rights, if any, are based on the articles of agreement;

Section 362.106 is broadened so that a bank's real estate development corporation can engage in activities involving government property;

Section 362.117 is modified so that a bank converting to a trust charter can retain its original incorporation date;

Section 362.170 is amended to permit a 1 or a 2 rated bank, wherever located, to employ a 25 percent legal loan limit and also allows a bank to invest up to two times the legal loan limit in stock of the Federal Home Loan Bank;

Sections 362.245 and 362.335 are both changed to allow a chief executive officer to be designated by a title other than president and, under very limited circumstances, to not be a director;

Sections 362.275 is modified to allow, under limited circumstances, action by the Board without a meeting;

Section 365.100 now provides for a higher late charge on motor vehicle time sales;

Section 408.140 is amended to allow a larger loan fee on consumer loans and to permit a loan fee on overdraft checking.

These provisions, if approved and signed by the Governor, will not take effect until August 28, 2002.

CHANGES IN REGULATIONS

The Division staff recently reviewed the regulations and proposed changes necessitated by various developments. The results will be published in the *Missouri Register* (July 1, 2002) and, having been approved, will become effective August 30, 2002. The changes which affect banks are as follows:

- **4 CSR 140-2.067 Community Development Corporations:** The old rule required that investments in these corporations be booked as "Other Assets." This change would remove that requirement and make the rule silent on that point.

- **4 CSR 140-2.070 Accounting for Other Real Estate (ORE):** The old rule required an appraisal if ORE had a recorded value exceeding the lesser of 5 percent of capital or $50,000. This was out-of-date due to inflation of real estate prices and federal appraisal requirements. The change requires an appraisal if the recorded value exceeds $250,000; however, if the value is $250,000 or less, a formal evaluation is required.

- **4 CSR 140-10.010 Regional Interstate Banking:** This state rule which preceded Reigle-Neal was outdated and repealed.

- **4 CSR 140-10.030 Acquisition of Missouri-based Banks by Holding Companies:** This rule now requires a filing of information with the Commissioner of Finance whenever a Missouri-based bank is acquired by a holding company; thereby providing the Commissioner an opportunity to comment on the acquisition.

INTERNET SERVICE PROVIDER SERVICES

When a bank offers banking information or services to customers through the Internet, many times customers who do not have Internet access will decline the offer. So, it has recently been asked whether a bank can legally offer or market the services of an Internet service provider (ISP) to customers of the bank and in return receive compensation from the ISP.

If the bank were to directly act as an agent for the ISP it would violate Section 362.200 RSMo due to illegal use of bank resources in trade or commerce. However, as an alternative the bank could act as a finder, bringing together a buyer and seller. The bank would be allowed to inform customers of the availability of the ISP services, distribute applications and assist customers in completing them. The bank could also receive a fee from the ISP based on the number of customers submitting their applications and subscribing for services. However, the information provided to the customers must clearly convey that the bank and the ISP are separate unrelated entities and that the bank has no responsibility for management or conduct of the ISP. Customers must understand that they are dealing with the ISP when subscribing and the bank must avoid any appearance that it is selling the ISP subscriptions.

REGULATION B - CAN YOU REQUIRE A SPOUSAL SIGNATURE?

Regulation B implements the Equal Credit Opportunity Act (ECOA) and it limits when a creditor may seek a spouse as a co-signor.

Generally, a creditor cannot ask for or require the signature of an applicant's spouse if the applicant requests individual credit and the applicant individually meets the creditor's standards for the amount and terms of the credit requested. If the applicant does not meet the creditor's standards, the creditor may require a co-signor but it cannot require that it be the applicant's spouse.

There is a major exception. If the request is for secured credit, the creditor may require the signature of the spouse or other person "on any instrument necessary. . . to make the property offered as security available to satisfy the debt in the event of default."

In summary, a creditor cannot require a spouse's signature on a note but can require such signature on the security agreement if needed to make the security interest enforceable.

I NEED TO CONTACT FIELD EXAMINERS OR SUPERVISORS

You are preparing for an examination and have a question regarding an item on the pre-examination list of materials needed, or you want to contact a field supervisor regarding a schedule change for the exit meeting, and your calls to the field office telephone number indicate no one is there today. What do you do? Many times a banker or a member of their staff will call the Division office in Jefferson City to obtain a phone number for a location where the field examiner or supervisor can be reached. While we are more than happy to provide you this information, there is also another alternative that will save you a phone call. All field examiners and supervisors can be contacted through our web site (www.missouri-finance.org). Simply go to our home page and click on "Personnel" then select the color coded section of the map where your bank is located. You will then be provided with a list showing each member of the field staff and the district supervisor for your bank. If you click on any one of their names, the individual e-mail address will be presented and thereby allow you to send a direct message. This map also allows you to contact any of the Consumer Credit, Trust Examiners or Division office staff by simply clicking on the respective boxes shown to the right of the map.

If you have not already utilized the e-mail feature, we encourage you to give it a try and hope you find it to be a useful communication tool.

2002 EXAMINERS' BANKING PRACTICES SURVEY

During each examination, Division of Finance examiners complete a survey that provides the Commissioner additional insight into current banking practices in state banks. The purpose of the survey is to solicit examiner impressions regarding general areas of lending, investments, funding and other activities. The responses provide early signals of changes in practices of Missouri's state-chartered banks.

HIGHLIGHTS

- The number of banks exhibiting strong loan growth has diminished since the high growth year of 2000. Real estate loans for construction, land development, financing commercial or agricultural property, together with non-real estate commercial loans show the largest increase.
- Very few banks loan money to high-risk entities or offer below market loan interest rates to attract customers.
- The number of banks which incurred "more-than-normal" risk to book new loans rose significantly in 2001, but interim 2002 numbers indicate a reversal. The most frequent underwriting risks cited in 2001 were lack of cash flow projections, liberal repayment terms, and collateral based loans with little emphasis on repayment source. Of concern, however, are banks with overall higher risk in general underwriting practices. The numbers of such institutions steadily increase with interim 2002 results reflecting 19 percent of the banks reviewed have elevated potential loan risk.
- The majority of banks examined in the 2000 to 2002 period experienced an increase in low quality assets, with the classifications-to-capital ratio rising an average of nine percent over the prior examination. The major source of new classifications is older established loans.
- The Federal Home Loan Bank continues to advance as funding source – over 70 percent of banks actively borrow.
- Nontraditional products and services are offered in 75 percent of the banks included in the 2002 survey.

	2000	2001	2002*
Number of Bank Surveys	107	136	37
LENDING			
Increased lending activity by at least 20% since the last examination.	57%	45%	32%
• Of banks that increased lending activity at least 20%, the activity occurred in the following areas:			
RE/Construction/Land Development	22%	19%	24%
RE/Agricultural	11%	10%	20%
RE/Commercial/Industrial	19%	20%	16%
RE/Residential	14%	17%	8%
Agricultural	8%	5%	0%
Commercial/Industrial	19%	20%	20%
Consumer	7%	9%	12%
Making loans in high-risk segments.	15%	9%	11%
• Of banks that loan to high-risk segments, the activity occurred in the following areas:			
Subprime	25%	15%	0%
Dealer paper	75%	70%	100%
Low or no-documentation business loans		8%	0%
High loan-to-value home equity lending		7%	0%
Offering below market interest rates or reduced rates to attract loans.	4%	4%	3%
Incurring "more-than-normal" risk in underwriting to book new loans.	17%	24%	8%
• Of banks incurring more-than-normal risk, specific practices are:			
Collateral based loans	30%	22%	38%
Reduced collateral margins	19%	13%	0%
No cash flow projections	19%	30%	25%
Liberal repayment terms	16%	23%	25%
Waiving guarantees or documentation	8%	5%	0%
Other	8%	7%	12%

* Data is year-to-date 2002.

	2000	2001	2002*
Current underwriting practices represent:			
More-than-normal risk	12%	13%	19%
Substantial risk	0%	1%	1%
Differences between actual lending practices and written policies are considered:			
Moderate	18%	13%	14%
Substantial	4%	4%	1%
Credit scoring models used for loan decisions.	8%	10%	8%
• Of banks using credit scoring, types of loans scored are:			
Credit card	21%	5%	20%
Consumer	42%	65%	40%
Residential real estate	16%	15%	40%
Small business	16%	15%	0%
Other	5%	0%	0%
The classifications-to-capital ratio increased from the prior examination.	58%	61%	65%
• Average increase in the classification ratio.	9%	11%	8%
• Causes of increased classifications are:			
Eased underwriting standards	4%	3%	7%
Deterioration in new loans	14%	15%	15%
Deterioration in older loans	50%	41%	51%
Participations or out-of-territory credits	5%	3%	2%
Economic conditions	6%	27%	12%
Changes in lending personnel	2%	0%	2%
New types of lending activity	6%	0%	0%
Other	13%	11%	11%
• Loan classifications are of the following types:			
RE/Construction/Land Development	9%	7%	8%
RE/Agriculture	8%	7%	10%
RE/Commercial	22%	20%	23%
RE/Residential	26%	26%	23%
Agricultural	8%	8%	6%
Commercial/Industrial	14%	21%	21%
Consumer	13%	11%	9%
INVESTMENTS			
Purchased securities without a full understanding of the characteristics of the issue.	3%	2%	0%
Differences in actual investment practices and written policies are considered:			
Moderate	5%	3%	5%
Substantial	0%	0%	0%
FUNDING			
Borrowing line established with the Federal Home Loan Bank.	63%	74%	78%
• Of banks that have borrowing lines, those actively borrowing are:	68%	71%	72%
OTHER			
Hold off-balance sheet derivatives.	2%	2%	3%
Engaged in nontraditional activity.	41%	38%	75%
• Of banks engaged in activity, types are:			
Nondeposit investment sales	71%	64%	32%
Insurance sales	21%	25%	9%
RE secondary market sales			20%
Non-transactional web site			13%
Transactional web site			23%
Other	8%	11%	3%

* Data is year-to-date 2002.

BANKING PERFORMANCE

Missouri state chartered banks continue to exhibit substantial growth. As of March 31, 2002, 306 state chartered banks held $43.4 billion in assets and $35.9 billion in deposits. These totals represent growth rates of 10.0 and 9.9 percent, respectively, since March 31, 2001 when 313 banks held assets and deposits of $39.4 billion and $32.6 billion respectively. Most of the growth was invested in loans, which increased by 10.2 percent, with funding coming primarily from core deposits. During the preceding twelve months, ten banks left the state banking system through mergers, consolidations, or charter conversion. Three new banks were chartered.

The net interest margin and return on assets have both improved for the first quarter of 2002 compared to 2001 results. The apparent end to declining interest margins bodes well for increased earnings performance for the remainder of this year.

Selected performance measurements of Missouri state chartered banks include:

	Missouri State Banks		
	March 31, 2002	**December 31, 2001**	**December 31, 2000**
Yield on Earning Assets	6.50	7.22	7.87
Cost of Funding Earning Assets	2.62	3.54	3.98
Net Interest Margin	3.88	3.68	3.89
Loan Loss Provision to Average Assets	0.24	0.29	0.23
Return on Assets	1.15	1.05	1.12
Net Charge-offs to Loans	0.03	0.32	0.19
Non Performing Loans to Total Loans	1.70	2.42	2.25
Tangible Equity Capital to Assets	8.71	8.69	8.74
Loans to Assets	68.49	68.64	69.41
Earning Assets to Total Assets	93.14	92.66	93.20

Missouri state chartered banks continue to be in good condition. All but ten banks (97 percent) were profitable as of March 31, 2002. Despite the overall strong condition of Missouri state-chartered banks, the number of problem banks increased from nine on December 31, 2001 to 14 on March 31, 2002. We are confident, however, that several of these institutions will improve to satisfactory condition in the next few months.